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No. 921

In the Supreme Court of the United States

October Term, 1962

[redacted]

v.

[redacted]

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE [redacted] CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

[redacted]
Attorney General,
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In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 991

THE CLIFTON INVESTMENT CO., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. 42–51) are reported at 36 T.C. 569. The opinion of the court of appeals (Pet. 29–34) is reported at 312 F. 2d 719, and the order denying the taxpayer's petition for rehearing *en banc* (Pet. 35) is not officially reported.

JURISDICTION

The judgment of the court of appeals was entered on February 6, 1963 (Pet. 29), and rehearing was denied on March 11, 1963 (Pet. 35). The petition for a writ of certiorari was filed on April 5, 1963. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1).

QUESTIONS PRESENTED

1. Whether a hotel in New York City, acquired (through the purchase of the controlling stock in a corporation) by the taxpayer with the proceeds from the sale of its office building to the City of Cincinnati under threat of eminent domain, constituted property "similar or related in service or use" to the converted property within the meaning of Section 1033 (a)(3) of the Internal Revenue Code of 1954, so as to entitle the taxpayer to treat the transaction as a tax-free involuntary conversion.

2. Whether the taxpayer is entitled to have its petition for rehearing passed upon by the entire court, rather than merely the panel (composed of one circuit judge and two district judges) which heard and decided the case.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Section 1033 of the Internal Revenue Code of 1954, Sections 46 and 292 of Title 28 of the United States Code, and Section 1.1033(a)-2 of Treasury Regulations on Income Tax (1954 Code) are set forth in the Appendix, *infra*, pp. 9–16.

STATEMENT

The taxpayer is a real estate investment corporation. In 1956, under threat of eminent domain, it sold to the City of Cincinnati a six-story office building, known as the United Bank Building, which had been held for the production of rental income from commercial tenants. The proceeds of the sale were used by the taxpayer to purchase eighty per cent of the

outstanding stock of Times Square Hotel of New York, Inc., a corporation which in turn purchased the Hotel Times Square in New York City.[1] (Pet. 29.)

The hotel, like the bank building, was held for the production of rental income. However, whereas the office building required only two employees (a janitor and an elevator operator), a staff of between 130 and 140 employees was needed to operate the hotel and service its guests and commercial tenants. Moreover, in connection with the guest room facilities from which it derived approximately 96 per cent of its income, the hotel provided furniture, linens, and daily personal services of every description. The office building, on the other hand, though some of its tenants had living quarters on the premises, furnished none of the services typically demanded by hotel guests. And whereas space in the office building was rented to commercial tenants of all types, commercial space in the hotel was leased for the most part to tenants whose occupations fitted in with the operation of the hotel and contributed to the service of its guests.[2] (Pet. 32–33.)

In its income tax return for the fiscal year ending November 30, 1956, the taxpayer reported the sale

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[1] The fact that the replacement property was acquired by taxpayer through the purchase of a controlling interest in a corporation owning the property does not in itself disqualify the transaction from nonrecognition treatment. See Section 1033(a)(3)(A) of the Internal Revenue Code of 1954, Appendix, *infra*, p. 9.

[2] The hotel space was occupied, *inter alia*, by a dentist's office, a newsstand, a theater ticket office, a valet, a barbershop, a luggage shop, a public stenographer office, and restaurants. (Pet. 46.)

of the office building as a nontaxable transaction under Section 1033(a) of the Internal Revenue Code of 1954 (Appendix, *infra*, p. 9), maintaining that the hotel which it purchased with the proceeds was "similar or related in service or use" to the property it had been forced to sell, both having been held for rental income. The Commissioner, however, ruled that the gain from the sale of the office building was recognizable, and assessed a deficiency in the amount of $19,057.09. The Tax Court upheld the Commissioner's determination.

The court of appeals, though rejecting the "functional test" employed by the Tax Court, nonetheless affirmed its decision on the ground that the two properties differed so materially in what they demanded of the taxpayer by way of services, management activity, and tenant relations, as to render Section 1033(a) inapplicable.

The taxpayer thereupon filed a petition for rehearing *en banc*. Rehearing was denied by the division of the court which had decided the case, and the taxpayer filed a timely petition for certiorari.

ARGUMENT

1. The taxpayer urges that this Court grant certiorari in order to resolve a conflict among the circuits as to the proper legal test to be used in applying Section 1033(a), Appendix, *infra*, p. 9, to situations in which the taxpayer is not the end user of the property, but merely an investor, *e.g.*, an owner-lessor. That conflict, however, has no bearing upon the disposition of this case. For, as we develop below, the court of appeals expressly rejected the test urged by the govern-

ment and adopted that espoused by the taxpayer—holding, however, that under the circumstances of this case the condemned and replacement properties do not possess the requisite similarity even under the test most favorable to the taxpayer.

In *McCaffrey* v. *Commissioner*, 275 F. 2d 27, certiorari denied, 363 U.S. 828, the Third Circuit, following a long-standing practice of the Tax Court, held that in determining whether properties are "similar or related in service or use" under Section 1033(a), the same criterion should be employed whether the taxpayer holds the property as an investor or uses it in his own trade or business. That test—the so-called "functional test"—involves a comparison of the physical characteristics of the premises and the uses made of them by the actual occupants. However, the Second, Fourth, Seventh, Eighth, and here the Sixth, Circuits have held that the "functional test," repeatedly advocated by the government, is inappropriate where the taxpayer is not himself the occupant. Those courts (except perhaps the Fourth Circuit) have followed the test laid down by the Second Circuit in *Liant Record, Inc.* v. *Commissioner*, 303 F. 2d 326, 329—one which requires a "comparison of the services or uses of the original and replacement properties *to the taxpayer-owner*," and, specifically, a comparison of such factors as "the extent and type of the lessor's management activity, the amount and kind of services rendered by him to the tenants, and the nature of his business risks connected with the properties."[3] In the

[3] The *Liant Record* test was accepted by the Seventh Circuit in *Pohn* v. *Commissioner*, 309 F. 2d 427, and by the Sixth Circuit in the very recent case of *Capitol Motor Car Co.* v.

instant case the government argued for the "functional test", the taxpayer for the *Liant Record* standard. And the Sixth Circuit expressly adopted the latter. It went on to hold, however—correctly, we think—that what the hotel demanded of the taxpayer in the way of management, services, and relations to its tenants varied materially from what was demanded by the office building, so that even in terms of the considerations deemed relevant in *Liant Record*, the taxpayer could not prevail. Thus, the only issue before this Court is whether the *Liant Record* test was correctly applied to the facts of this case. And on that issue, the decision below is plainly not in conflict with the decision of any other court.

Furthermore, the importance of the general problem was greatly reduced by the enactment in 1958 of subsection (g) of Section 1033,[4] which provides that in most cases of involuntary conversion of real prop-

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Commissioner, 314 F. 2d 469, decided adversely to the Commissioner. The Eighth Circuit adopted the Second Circuit's test but added the requirement that there must also be "a reasonable similarity in the leased premises themselves". *Loco Realty Co.* v. *Commissioner*, 306 F. 2d 207, 215. The test earlier enunciated by the Fourth Circuit, *Steuart Brothers* v. *Commissioner*, 261 F. 2d 580, 584, states that the properties must be of "the same general class", and it is likely that if asked to promulgate standards necessary for the application of the test it would adopt those of the Second Circuit, for *Steuart* cites the Tax Court opinion in *Winter Realty & Construction Co.* v. *Commissioner*, 2 T.C. 38, with approval, and it seems apparent that it is from the Second Circuit's consideration of *Winter Realty*, 149 F. 2d 567, 570 (C.A. 2d), that the *Liant Record* test was later ~~denied~~ derived.

[4] The new subsection was added by Section 46(a) of the Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606.

erty, the "similar or related in service or use" requirement will be deemed satisfied if the newly acquired property is of "like kind." Under the "like kind" standard—which has long been the determinant of tax recognition or non-recognition in the case of voluntary exchanges under Section 1031—any replacement of real property by other real property would qualify as a tax-free transaction. True, the amendment does not apply in the situation where, as here, the property taken is replaced by stock representing the control of a corporation which owns the replacement property; but very few of the litigated cases involve this feature.

2. There is no merit to taxpayer's contention that its petition for rehearing, since it was addressed to the court *en banc*, should have been passed upon by the entire court. *Western Pacific Railroad Case*, 345 U.S. 247.

CONCLUSION

For the foregoing reasons, we respectfully submit that the petition for a writ of certiorari should be denied.

Respectfully submitted.

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MAY 1963.

[1] See S. Rep. No. 1983, 85th Cong., 2d Sess., pp. 72–73 (1958–3 Cum. Bull. 922, 993–994).

APPENDIX

Internal Revenue Code of 1954:

SEC. 1033. INVOLUNTARY CONVERSIONS.

(a) *General Rule.*—If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsory or involuntarily converted—

* * * * *

(3) *Conversion into money where disposition occurred after 1950.*—Into money or into property not similar or related in service or use to the converted property (as defined in paragraph (2)) occurred after December 31, 1950, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph:

(A) *Nonrecognition of gain.*—If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, or purchases stock in the acquisition of control of a corporation owning such other property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock. Such election shall be made at such time and in such manner as the Secretary or his delegate may by regulations prescribe. * * *

* * * * * * *

(26 U.S.C. 1958 ed., Sec. 1033.)

28 U.S.C.:

SEC. 46. *Assignment of judges; divisions; hearings; quorum*

(a) Circuit judges shall sit on the court and its divisions in such order and at such times as the court directs.

(b) In each circuit the court may authorize the hearing and determination of cases and controversies by separate divisions, each consisting of three judges. Such divisions shall sit at the times and places and hear the cases and controversies assigned as the court directs.

(c) Cases and controversies shall be heard and determined by a court or division of not more than three judges, unless a hearing or rehearing before the court in banc is ordered by a majority of the circuit judges of the circuit who are in active service. A court in banc shall consist of all active circuit judges of the circuit.

(d) A majority of the number of judges authorized to constitute a court or division thereof, as provided in paragraph (c), shall constitute a quorum.

* * * * *

SEC. 292. [as amended by Sec. 3, Act of August 25, 1958, P.L. 85–755, 72 Stat. 848.] *District judges.*

(a) The chief judge of a circuit may designate and assign one or more district judges within the circuit to sit upon the court of appeals or a division thereof whenever the business of that court so requires. Such designations or assignments shall be in conformity with the rules or orders of the court of appeals of the circuit.

(b) The chief judge of a circuit may, in the public interest, designate and assign temporarily any district judge of the circuit to hold a district court in any district within the circuit.

(c) The Chief Justice of the United States may designate and assign temporarily a dis-

trict judge of one circuit for service in another circuit, either in a district court or court of appeals, upon presentation of a certificate of necessity by the chief judge or circuit justice of the circuit wherein the need arises.

(d) The Chief Justice of the United States may designate and assign temporarily any district judge to serve as a judge of the Court of Claims, the Court of Customs and Patent Appeals or the Customs Court upon presentation to him of a certificate of necessity by the chief judge of the court in which the need arises.

Treasury Regulations (1954 Code):

SECTION 1.1033(a)-2. *Involuntary conversion where disposition of the converted property occurred after December 31, 1950.*—(a) *In general.*—This section applies only with respect to involuntary conversions where the disposition of the converted property occurred after December 31, 1950, and where the proceeds are received in a taxable year to which the Internal Revenue Code of 1954 applies. The term "disposition of the converted property" means the destruction, theft, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation.

(b) *Conversion into similar property.*—If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted only into property similar or related in service or use to the property so converted, no gain shall be recognized. Such nonrecognition of gain is mandatory.

(c) *Conversion into money or into dissimilar property.*—(1) If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involun-

tarily converted into money or into property not similar or related in service or use to the converted property, the gain, if any, shall be recognized, at the election of the taxpayer, only to the extent that the amount realized upon such conversion exceeds the cost of other property purchased by the taxpayer which is similar or related in service or use to the property so converted, or the cost of stock of a corporation owning such other property which is purchased by the taxpayer in the acquisition of control of such corporation, if the taxpayer purchased such other property, or such stock, for the purpose of replacing the property so converted and during the period specified in subparagraph (3) of this paragraph. For the purposes of section 1033 the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

(2) All of the details in connection with an involuntary conversion of property at a gain (including those relating to the replacement of the converted property, or a decision not to replace, or the expiration of the period for replacement) shall be reported in the return for the taxable year or years in which any of such gain is realized. An election to have such gain recognized only to the extent provided in subparagraph (1) of this paragraph shall be made by including such gain in gross income for such year or years only to such extent. If, at the time of filing such a return, the period within which the converted property must be replaced has expired, or if such an election is not desired, the gain should be included in gross income for such year or years in the regular manner. A failure to so include such gain in gross income in the regular manner shall be deemed to be an election by the taxpayer to have such gain rec-

ognized only to the extent provided in subparagraph (1) of this paragraph even though the details in connection with the conversion are not reported in such return. If, after having made an election under section 1033(a)(3), the converted property is not replaced within the required period of time, or replacement is made at a cost lower than was anticipated at the time of the election, or a decision is made not to replace, the tax liability for the year or years for which the election was made shall be recomputed. Such recomputation should be in the form of an "amended return". If a decision is made to make an election under section 1033 (a)(3) after the filing of the return and the payment of the tax for the year or years in which any of the gain on an involuntary conversion is realized and before the expiration of the period within which the converted property must be replaced, a claim for credit or refund for such year or years should be filed. If the replacement of the converted property occurs in a year or years in which none of the gain on the conversion is realized, all of the details in connection with such replacement shall be reported in the return for such year or years.

(3) The period referred to in subparagraphs (1) and (2) of this paragraph is the period of time commencing with the date of the disposition of the converted property, or the date of the beginning of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier, and ending one year after the close of the first taxable year in which any part of the gain upon the conversion is realized, or at the close of such later date as may be designated pursuant to an application of the taxpayer. Such application shall be made prior to the expiration of the one year after the close of the first taxable year in which any part of the gain from the conversion is realized, and shall contain all of the details

in connection with the involuntary conversion. Such application shall be made to the district director for the internal revenue district in which the return is filed for the first taxable year in which any of the gain from the involuntary conversion is realized. No extension of time shall be granted pursuant to such application unless the taxpayer can show reasonable cause for not being able to replace the converted property within the required period of time.

(4) Property or stock purchased before the disposition of the converted property shall be considered to have been purchased for the purpose of replacing the converted property only if such property or stock is held by the taxpayer on the date of the disposition of the converted property. Property or stock shall be considered to have been purchased only if, but for the provisions of section 1033(c), the unadjusted basis of such property or stock would be its cost to the taxpayer within the meaning of section 1012. If the taxpayer's unadjusted basis of the replacement property would be determined, in the absence of section 1033(c), under any of the exceptions referred to in section 1012, the unadjusted basis of the property would not be its cost within the meaning of section 1012. For example, if property similar or related in service or use to the converted property is acquired by gift and its basis is determined under section 1015, such property will not qualify as a replacement for the converted property.

(5) If a taxpayer makes an election under section 1033(a)(3), any deficiency, for any taxable year in which any part of the gain upon the conversion is realized, which is attributable to such gain may be assessed at any time before the expiration of three years from the date the district director with whom the return for such year has been filed is notified by the taxpayer

of the replacement of the converted property or of an intention not to replace, or of a failure to replace, within the required period, notwithstanding the provisions of section 6212(c) or the provisions of any other law or rule of law which would otherwise prevent such assessment. If replacement has been made, such notification shall contain all of the details in connection with such replacement. Such notification should be made in the return for the taxable year or years in which the replacement occurs, or the intention not to replace is formed, or the period for replacement expires, if this return is filed with such district director. If this return is not filed with such district director, then such notification shall be made to such district director at the time of filing this return. If the taxpayer so desires, he may, in either event, also notify such district director before the filing of such return.

(6) If a taxpayer makes an election under section 1033(a)(3) and the replacement property or stock was purchased before the beginning of the last taxable year in which any part of the gain upon the conversion is realized, any deficiency, for any taxable year ending before such last taxable year, which is attributable to such election may be assessed at any time before the expiration of the period within which a deficiency for such last taxable year may be assessed, notwithstanding the provisions of section 6212(c) or 6501 or the provisions of any law or rule of law which would otherwise prevent such assessment.

(7) If the taxpayer makes an election under section 1033(a)(3), the gain upon the conversion shall be recognized to the extent that the amount realized upon such conversion exceeds the cost of the replacement property or stock, regardless of whether such amount is realized in one or more taxable years.

(8) The proceeds of a use and occupancy insurance contract, which by its terms insured against actual loss sustained of net profits in the business, are not proceeds of an involuntary conversion but are income in the same manner that the profits for which they are substituted would have been.

(9) There is no investment in property similar in character and devoted to a similar use if—

(i) The proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate.

(ii) The proceeds of conversion of real property are applied in reduction of indebtedness previously incurred in the purchase of a leasehold.

(iii) The owner of a requisitioned tug uses the proceeds to buy barges.

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